

Preliminary Report:
Transferable Ruble Debt Issues and Strategy

by

Peter T. Allen

for

Economic Policy Support Project

funded by

US Agency for International Development

14 March 2000

Outline of Contents

1. Background and Recent Developments on Soviet-era Debts
 - (i) The 1992 Zero-Option and the Valuation of TR Claims
 - (ii) The February 2000 London Club Agreement
 - (iii) Facts and Figures on Russia's Transferable Ruble Claims
 - (iv) The Record of Negotiations
 - (v) The Paris Club
2. Implications for Negotiating Strategy
 - (i) Hard Currency Valuation and the Ancien Regime
 - (ii) Impact of Russia's Financial Crisis and the London Club Deal
 - (iii) Political Changes in Moscow
 - (iv) The Paris Club Framework
 - (v) Variables in the Restructure
3. Debt Sustainability Analysis
4. Strategy and Tactics for Mongolia
 - (i) Timing
 - (ii) Alternative Approaches to Negotiations
 - (iii) Presentation of an Analysis of the Historical Record
5. Preparatory Work
6. Conclusions
7. Footnotes

1. Background and Recent Developments on Soviet-era Debts

(i.) The 1992 Zero-Option and the Value of TR Claims

Russia is now emerging from a financial crisis that began in August 1998. In the fourth quarter 1998, Russia defaulted on its Paris and London Club debts and in February 2000 renegotiated the London Club debt (US\$32 billion) including forgiveness of roughly 60% (total NPV). Russian Deputy Prime Minister Mikhail Kasyanov has said that the Ministry of Finance intends to seek comparable terms on the Paris Club debt (US\$43 billion) in the second half of this year.

The likelihood of 50-60% overall reduction on Russia's entire "Soviet-era" debt is an important milestone in the running debate over the value -- in the world of market economics -- of all debts incurred by CMEA members prior to the collapse of the Soviet Union in 1991. It will remove one of Russia's motives in collecting the TR debt, weaken its authority to demand repayment on what it now classifies "Soviet-era" debt. For itself,

Russia has, for itself, embraced the notion of debt service capacity as the only gauge for a sustainable debt burden.

Table 1:	
Russian Federation Balance Sheet at December 1991	
Under Zero-Option Agreement	
	<u>(US\$bn)</u>
Convertible Currency Debt	61.4
International Financial Institutions	0.0
Official Bilateral Creditors	37.1
London Club Creditors	15.5
Suppliers	8.8
Total Claims According to Russian Sources 1/	181.9
Convertible Currency Claims	35.1
Transferable Ruble Claims	146.7
Total Claims, Ruble Claims at Market Forex 2/	35.6
Convertible Currency Claims	35.1
Transferable Ruble Claims	0.5
Source: IMF	
1/ Transferable ruble claims valued at 0.5556/US\$1	
2/ Transferable ruble claims valued at 150/US\$1	

These arrangements amount to a restructure of Russia's balance sheet of Soviet-era liabilities. When Russia assumed the external debt of the FSU in 1992 (under the Zero Option Agreement) it effectively recognized a pro forma balance sheet including FSU external claims surrendered by the republics (see table 1). As table 1 shows, the nominal value of the claims at the Gosbank official exchange rate exceeded the debt by a wide margin. Russia upheld the full contractual burden of the hard currency liabilities Paris and London Club restructurings in 1992-1997, albeit with temporary cash flow rescheduling. But Russia's inability to sustain this whole arrangement was one of the main causes of the 1998 financial crisis.

(ii.) The February 2000 London Club Agreement

Summary of the Terms. On February 11, Russia took an important step toward ending its financial crisis. Officials announced an agreement on the terms of a restructure with the London Club of commercial creditors. Russia's debt to the London Club totals US\$31.8 billion, including US\$22.4 billion of Principal Loans (Prins) and US\$6.8 billion of Interest Arrears Notes (Ians). These instruments arose from a prior restructure in 1997, and fell into default in December 1998. The origin of this debt was Soviet-era loans largely from German banks. Deputy Prime Minister Mikhail Kasyanov predicted the restructuring will close during the second quarter of this year. (The terms and analysis of the London Club restructuring are summarized in Appendix 1.)

Under the agreement, Russia will issue new 30-year Eurobonds to replace this debt, at a discount of 37.5% for the PRINs and 33% for IANs. Concessional coupon rates on this bond grant Russia additional forgiveness. The interest rate on the 30-year Eurobond will be 2.25% for the first six months, 2.5% for the second six months, 5% from years two through seven and 7.5% from year eight through maturity. Russia will issue new 10-year Eurobonds for an estimated US\$2.8 billion of interest arrears accumulated since the default. These bonds will be exchanged at par, and carry a market rate of interest (8.25% per annum) hence they grant no forgiveness.

This restructure will cut the nominal amount of the London Club debt by 36.5% or US\$10.7 billion, to from US\$31.8 billion to US\$21 billion. Additionally, the present discounted value of forgiveness in the form of concessional terms of the new 30-year Eurobond is worth another 35% of the value of the new bond or 22% of value of the old debt. So the total value of the permanent forgiveness Russia will receive on the London Club debt is approximately 58.7%. (See Appendix 1 for details on these calculations.) This equivalent to the “Naples Terms” of the Paris Club.

Rationale Offered by Russian Officials. Members of the London Club privately expressed disappointment that Russian officials were not required -- and did not offer -- a formal analysis of financial need to justify this large forgiveness. Secondary market considerations were the predominant determinant of the terms. When negotiations began in September 1999, the Prin and Ian instruments were trading in the secondary market at only 6-8 percent of their face value. At these levels, Russia was able to offer new bonds with a large discount and low coupon rates that still gave bondholders a significant increment in their market value (up to about 26-27 percent of face value in the secondary market currently). Secondary market factors are not germane to the Mongolia-Russia bilateral transferable ruble debt, but the key point is that Russian authorities used secondary market conditions to secure a maximum amount of forgiveness.

The thinking of senior Russian officials seems to have galvanized in mid-November around a London Club agreement which cut the nominal value of the debt by 40%, plus any additional concessional terms on bonds issued. Various public statements by Russian officials at the time provide insight into the rationale.

1. The actual cause of Russia's default was the overall weakness of public sector finances. However, Russian officials did not make a case before the London Club for forgiveness based on an amount of available fiscal resources. This line of argument may have been questioned by creditors as the overall fiscal deficit is estimated to have declined to 1.7% of GDP in 1999 from 5.0% in 1998. ^{1/}
2. Russia's balance of payment has not been a binding constraint and for the past year due in large part to the steady rise of global oil prices. Russia ran a current account surplus of approximately US\$11 billion last year. ^{2/} Chronic bouts of capital flight, however, remains a problem.

3. In fact the main rationale for a 40% discount was political, and recalled the abortive 1991-92 Memorandum of Understanding (MOU) between the former Soviet Republics. Shortly after the 1998 default on external debt, senior Russian officials began to draw a distinction between “Soviet-era” and “post-Soviet era” debt. Several senior officials said last November that Russia had made a mistake in assuming the entire debt of the FSU. Concurrent with these statements, Minister Kasyanov began to say in his public statements that Russian wanted a 40% discount on the exchange, that is to recognize a 60% of the FSU external debt.^{3/} This 60% corresponds to Russia’s portion of the FSU debt, i.e. the portion that it would have accepted under the MOU. (See table 2)

Table 2:	
Percent Shares of USSR External Debt	
Under the 1991 Memorandum of Understanding	
	<u>in percent</u>
Russian Federation	61.3%
Ukraine	16.4%
Belarus	4.1%
Uzbekistan	3.3%
Kazakstan	3.9%
Georgia	1.6%
Azerbaijan	1.6%
Lithuania	1.4%
Moldova	1.3%
Latvia	1.1%
Kyrgyz Republic	1.0%
Tajikstan	0.8%
Armenia	0.9%
Turkmenistan	0.7%
Estonia	0.6%
Total	100.0%
Source: IMF	

The new distinction between the “Soviet era” and “Russian era” debt was also marked by Russia’s success keeping US\$16 billion of eurobonds issued by the Russia Federation out of the default and out of the London Club deal.

(iii.) Facts and Figures on Russia’s Transferable Ruble Claims

External Asset Position of Russia in 1991. The Soviet Union had large gross assets and liabilities to the outside world when it broke up in December 1991. It had external debt equivalent to US\$61.4 billion and external assets which it valued at US\$182 billion (see table 1). The debts were mostly in convertible currencies, but assets were mostly in non-convertible transferable rubles (TR). External assets included loans to (or claims on) developing countries (including members of the Council for Mutual Economic Assistance, CMEA), foreign exchange reserves, and embassies and real estate holdings abroad.

CMEA. When the CMEA ^{4/} ceased operations in 1991, the USSR was a net creditor to the CMEA as a whole but a net debtor to Eastern Europe CMEA members. CMEA trade and investment flows were determined in annual protocols and 5-year plans. Resulting credit flows reflected political, not economic or financial, factors. Most trade and investment flows in the CMEA were denominated in transferable rubles. The TR was a “unit of value” only, used by the State Bank of the USSR (the Gosbank) to clear payments within CMEA. Upon the breakup of the CMEA many debtors disputed the official conversion rate for TR claims.

Table 3: Russian Federation Claims on Developing Countries as of End-1993 (according to Russian Sources, reported by IMF)			
	Total Claims (US\$bn)	Of Which: Ruble Denominated (US\$bn) a/	Ruble Denominated (TR\$bn)
Total	173.0	137.9	80.7
Countries Reporting to the World Bank:	113.9	87.3	51.1
Asia	60.3	58.4	34.2
of which: Mongolia	17.6	17.6	10.3
Vietnam	18.1	18.1	10.6
Europe	9.2	9.2	5.4
North Africa/Middle East	26.6	18.4	10.8
Sub-Sahara Africa	14.7	1.2	0.7
Latin America	3.1	0.0	0.0
Others b/	59.1	50.6	29.6

Source: IMF, *Official Financing for Developing Countries* (December 1995), Appendix III, p.96

a/ Ruble denominated claims converted into US\$ with the official exchange rate of the ruble prevailing at the end of 1993, TR0.5854/US\$1.

b/ Includes Afghanistan, Cuba, Iraq, Libya, and the Democratic Peoples Republic of Korea

Russia's TR Claims and the “Official” Rate. At the end of 1993 (for which detailed data is available in an IMF study ^{5/}) the Russia Federation had TR-denominated claims on 51 developing countries totaling TR81 billion. Russia maintains the position that these claims should be valued at the Gosbank rate, which was TR0.5854 per US\$1 at the end of

1993. This put the claims at US\$138 billion. Cuba, Mongolia and Vietnam owe the lion's share of this debt, and other major debtors were Afghanistan, Ethiopia, India, Iraq, Nicaragua, and Syria. Russia's official position was codified in the terms of Russia's accession to membership of the Paris Club of creditors in September 1997.

The alternate laws of economics. The debate over the appropriate conversion rate really is a debate over the relevance to the world of market economics of the entire structure of debts incurred under the Soviet-era economic system and laws. Rolled over routinely, the TR debts are the financial manifestation of a system of non-market prices. The case of Mongolia demonstrates how this system produced debt levels wholly out of line with economic activity thereby drawing into question whether repayment was ever intended by creditor or debtor.

(iv.) The Record of Negotiations

Notwithstanding its official stance, Russia reportedly has agreed to rates of 5-6 TR per US\$ in several bilateral restructuring agreements (Hungary, GDR, Bulgaria and Poland), other conversion rates for others (India), and privately has offered US\$1=TR1 (Mongolia, Vietnam). Information on bilateral agreements is limited. I have prepared a partial list of stock-of-debt agreements from publicly available sources, attached as Appendix 2.

There have been few stock-of-debt ^{6/}restructurings since 1998 due to the Russia financial crisis. Russian authorities seem to approach bilateral negotiations on a case-by-case basis. There appeared to be no sequence, pattern or trend to the terms offered debtors, other than a failure to resolve, or even to have entered into serious talks, on the debts of the largest TR debtors, Mongolia, Vietnam and Cuba. These cases will require deep forgiveness of 90-100%, plus concessional terms on any remaining amounts. Terms seem to be heavily influenced by politics and the size of TR debt.

Russia has, however, reached a number of successful stock-of-debt agreements, most at the official Gosbank conversion rate. It appears as though forgiveness of 50% or less was adequate to resolve many of these situations. Several have been cash buybacks at large discounts, including 50% (Jordan, 1992), 68% (Nigeria, 1996), and 87% (Peru, 1996). A number have granted forgiveness ranging from 70% (Angola) to 90% (Nicaragua, Madagascar), typically in return for cash settlement of the remaining balance.

(v.) The Paris Club

Russia's Membership in the Paris Club as a Creditor. Uniquely, Russia is a major debtor and creditor of the Paris Club. In September 1997, Russia agreed with the Paris Club on terms to participate as a creditor. Russia may have intended this as a framework for resolution of the large TR debts. However, the 1998-99 financial crisis has required it to focus on its own debt problems. This may continue until the second half of this year, when Minister Kasyanov said he intends to seek a stock-of-debt restructure on Russia's debt to the Paris Club matching the 50-60% negotiated with the London Club.

Russia's Paris Club accession established three guidelines for treatment of the transferable ruble claims:

- 1) conversion of transferable rubles claims to hard currency at the Gosbank "official" exchange rate pending in 1992, or TR0.6 per US\$1,
- 2) special up-front discounts,
- 3) post-discount claims would then be subject to the Paris Club restructuring terms.

Under these guidelines, Russia can grant more, but not less, forgiveness than granted by the Paris Club including to candidates of the Highly Indebted Poor Country (HIPC) Initiative. Each of the three major TR debtors is a present or prospective candidate for HIPC terms.

HIPC. Mongolia is not officially a "HIPC country." This is probably because Mongolia's Paris Club debt, defined by the IMF to exclude TR debt, is only US\$300 million or less that one-half of the total. Without the Russian debt, Paris Club debt specifically and external debt generally is not a problem for Mongolia.^{7/} According to the IMF, Mongolia's external debt at the end of 1998 was 139% of exports, well below the key HIPC threshold of "sustainability" of 200-250% of exports. It is even beneath the lower, 150% debt-to-export threshold of the "enhanced HIPC."

Nevertheless, Mongolia seems to be a solid candidate for HIPC if the transferable ruble debt is included. According to the IMF, "eligibility for receiving exceptional assistance is limited to countries eligible for International Development Association (IDA) loans and for the Enhanced Structural Adjustment Facility (ESAF) that have established a strong track record of performance under programs supported by the IMF and the World Bank and that are not expected to achieve a sustainable external debt situation even under the full use of traditional debt relief mechanisms."^{8/} Including the transferable ruble debt into Mongolia's total at the Gosbank official exchange rate, the debt to export ratio would rise to 3,315%.

The HIPC Initiative was introduced in September 1996, and new "enhanced" version approved by the IMF Executive Board in December 1999. Under enhanced HIPC, the Paris Club has agreed to increase debt reduction in NPV terms to up to 90% or more, if needed, on a case-by-case basis.^{9/} These terms have not yet been implemented, as funding has not yet been approved by the U.S. Congress among others. These terms follow on the sequence of Paris Club relief terms: Toronto (up to 33%), Trinidad (up to 50%), Naples (up to 67%) and Lyon (up to 80%).

2. Implications for Negotiating Strategy

(i.) Hard Currency Valuation and the Ancien Regime.

Under the official Russia valuation framework, Mongolia's TR10.3 billion debt is equivalent to US\$17.6 billion, 1,706% of GDP and 3,240% of exports of goods and services. At an exchange ratio of TR1 = US\$1, the debt is equal to US\$10.3 billion, 1,000% of GDP and 1,900% of exports. Even assuming as stylized Paris Club stock-of-debt reduction under Naples (50-67%) or Lyon (up to 80%) terms, the remaining debt would exceed by a wide margin any conventional measure of debt sustainability such as the "enhanced HIPC" threshold of 150% of exports.

The magnitude of this debt is entirely arbitrary with no bearing on the size of the Mongolian economy or its capacity to produce resources for debt service. There exists no international formula, convention, rule, or precedent in the history of international sovereign rescheduling to solve this essential arbitrariness. Only an evaluation of debt capacity and sustainability can do this.

The legal basis of individual loans is weak. Individual credit agreements were governed by the laws of the USSR and the CMEA. The demise of these institutions removes the legal jurisdiction from Russia's TR claims on Mongolia. If the law of Russia is a successor, this at least leaves open a question as to the genuine authority to sue Mongolia to collect these claims. Russia must accept this on its face.

Russia has already recognized that the economic basis of the debts is a question mark by offering Mongolia forgiveness in prior talks. Other than this, the record of the past negotiations is largely irrelevant to a solution.

(ii.) Impact of Russia's Financial Crisis and the London Club Deal

The February 11 London Club agreement, and the likelihood of 50-60% overall reduction on Russia's debt, provides an important new gauge of the value of all "Soviet-era" debt. The London Club Agreement can be interpreted as a repudiation by Russia of the 1992 Zero-Option Agreement, calling into question the economic viability of all debts incurred during the "Soviet era." The deep discount on Russia's liability side naturally makes it easier for Russia to grant similar discounts on the asset side. One interpretation of the London Club deal is that "Soviet-era debt" should be marked down by 50-60%, as a first step in any restructuring talks with Mongolia.

(iii.) Political Changes in Moscow

The forthcoming presidential election in Russia, and the expected election of President Vladimir Putin may provide backing for a pragmatic solution to the debt problem. It is widely anticipated that First Deputy Prime Minister (and Finance Minister) Mikhail Kasyanov will have a senior post in the new government, perhaps Prime Minister.

Kasyanov, as debt negotiator, negotiated both of Russia's London Club agreements. His personal experience parallels the failed Zero-Option and the attempt to maintain full value of Soviet-era debts and claims. He has fashioned Russia's strategy to obtain a substantial write-down on these debts from the London Club, and prospectively to the Paris Club. This background suggests that Kasyanov may be inclined to adopt a realistic approach to the TR claims on Mongolia based on sustainability and a write-down of effectively all of the TR debt.

(iv.) The Paris Club Framework

Since Russia's accession to the Paris Club, public statements by Finance Minister Kasyanov and other officials have suggested that Russia may have a preference to use the Paris Club framework for stock-of-debt restructuring that may require large-scale forgiveness. This may be in order to maximize amount of official forgiveness granted and thereby "goodwill" accruing to Russia. Enhanced HIPC terms appear to provide for a forgiveness of substantially all of the debt as Mongolia needs. Mongolia should have no particular preference for the precise steps taken (i.e. a high conversion rate versus a low conversion rate and high forgiveness percentage) as long as the end result is a forgiveness of substantially all of the debt.

(v.) Variables in the Restructure

The restructuring of transferable ruble debt has more variables than a normal bilateral re-negotiation where the debt is typically denominated in hard currency. The variables are:

- Conversion ratio,
- "Special" discount. Russia's accession to the Paris Club provides for special up-front discounts,
- Paris Club stock-of-debt forgiveness such as Lyon terms (i.e. 80% reduction),

Assuming that an amount of debt remains after these variables are defined, remaining variables are:

- Bond terms. This could grant Mongolia further PV savings,
- Criteria for "recognition" of the face amounts determined only in the presence of certain benchmarks for the successful transition of the Mongolian economy, such as capitalization of the local equity market.

3. Debt Sustainability Analysis

The only way to assign a hard currency value to the TR debt is through an assessment of the debt sustainability, or debt service capacity, of Mongolia. This is the only way to determine what part – if any – of the debt could be accepted. An evaluation along these lines should commence immediately.

According to the IMF, “a country can be considered to achieve external debt sustainability if it is expected to be able to meet its current and future external debt service obligations in full, without recourse to debt relief, rescheduling, or accumulation of arrears, and without compromising growth.”^{10/} The “enhanced HIPC” initiative defines an external debt sustainability threshold of 150% of exports for PRGF countries.

Using this as a guide, a sustainable level for Mongolia’s external debt is US\$800-900 million. According to the IMF, Mongolia’s external debt at the end of 1999 is estimated at US\$855 million, mid-way through this range. This cursory analysis suggests that a debt sustainability will show that a “HIPC sustainable” level of external debt for Mongolia will require a write-off of substantially all of the TR debt to Russia.

Any amounts of the TR debt that are accepted by Mongolia, would become part of the external debt on a par with all other debt for all purposes including IMF surveillance and assessment of international rating agencies. This could reduce Mongolia’s access to concessional lending from official institutions. Any difficulty in servicing these amounts would have adverse consequences for Mongolia’s presence in international capital markets.

4. Strategy and Tactics for Mongolia

(i.) Timing

As a general matter in sovereign international debt, timing is on the side of the debtor in a situation like this. Debt that remains in default for a period of years becomes difficult to collect, and the sanction of nonpayment gradually dissipates as international agencies and investors begin to restore relationships.

However, in another sense time is not on Mongolia’s side in this instance. Mongolia must rely on a close economic relationship with Russia in the future, as it did in the past. This contrasts with Vietnam and Cuba, who can rely on others for new investment. The enormity of the TR claim may pose a subtle barrier to Mongolia’s economic independence in the minds of potential investors. It raises the question why Russia – for its own self interest -- does not seem to want to remove this burden on its relationship with Mongolia, by simply writing it off. The delay in resolving this issue may be holding back Mongolia’s development.

(ii.) Alternative Negotiating Strategies

Mongolia should shift from a passive to an active strategy on this issue. Mongolia should not leave it to Russian officials to recognize a sustainable debt load for Mongolia or to become ready to grant the large scale forgiveness. Three basic alternatives for an active strategy make sense.

Alternative One: Approach the Paris Club on a negotiation under its auspices on TR debt. This would be highly unorthodox. Mongolia appears to qualify for treatment under the HIPC Initiative, but would only qualify as “highly indebted” in the context of the TR debt. This appears to be the preferred mechanism of Russia, and should be discussed with Russian officials beforehand. There are several important risks to this approach, though it appears as though the enhanced HIPC Initiative provides for the scope of forgiveness that Mongolia needs.

Alternative Two: Ask Russia to commence bilateral talks for a final solution. This framework would be appropriate to the extent that Mongolia differs with Russia on the Paris Club formula, does not qualify for HIPC, or otherwise does not think that the Paris Club framework can get to the desired end-game. One risk to the Paris Club framework is an implicit recognition of the official rate for conversion or something close to it. Russian authorities must understand that Mongolia can accept this if and only if the forgiveness ratio – whether in the form of a “special” up front discount followed by another discount under HIPC or any combination thereof – of substantially 100%.

Alternative Three: Raise the priority of a resolution of the TR debt within the framework of bilateral economic coordination talks between the two Governments. This approach would have the benefit of placing the TR issue in the broad framework of the future economic relationship between the two countries. This approach would keep the focus on the benefits to both countries of clearing the way for a “new” economic relationship with Mongolia. This framework might increase Mongolia’s leverage for requesting a substantial 100% write-off of the TR debt, perhaps granting special concessions or incentives for Russian companies to invest in Mongolia.

5. Preparatory Work

The Mongolian Government should begin preparing a proposal of its own. Such a proposal should have three main parts:

- Restructuring terms that are required for “sustainability,
- A detailed of the rationale behind “sustainability including fiscal and balance of payments constraints on government payment capacity,
- A detailed synopsis of the historical record, including perhaps a case study of project lending decision making during the prior “era.

(i.) Presentation of an Analysis of the Historical Record

Mongolia’s proposal should contain an explanation of how economic and financial relations between the two countries prior to the break up of the Soviet Union systematically discriminated against the Mongolian Republic. The way to do this is to compare all economic transactions against current world market prices. This report may be embarrassing to the Russian Government, and it would not want it to be released publicly.

6. Conclusions

- Finding a solution of this longstanding problem will require Mongolia to marshal superior resources – including the arguments developed in this paper and enlisting the support of international institutions and the international press – and deploying them at a time and place of maximum effect. This will not hurt, but will help, Mongolia’s future relationship with Russia and put it on a footing of mutual respect and self-interest.
- The February London Club agreement, and the likely 50-60% reduction on Russia’s entire “Soviet-era” debt, is an important milestone in the running debate over the value of all debts incurred by CMEA members prior to the collapse of the Soviet Union. It calls into question the viability of all these debts. One interpretation of the London Club deal is that “Soviet-era debt” should be marked down by 50-60%, as a first step in any restructuring talks with Mongolia.
- Russia joined the Paris Club as a creditor in September 1997. It may have intended this as a framework to resolve the large TR debts. The terms of Russia’s membership established a precise framework for treating highly-indebted transferable ruble debtors, and Russian officials appear to have a preference to use this framework.
- This framework, including Enhanced HIPC terms, appears to provide for forgiveness of sufficient magnitude (substantially all) to meet Mongolia’s needs. Mongolia should have no particular preference for the precise components of the forgiveness it receives as long as the end result is a forgiveness of substantially all of the debt.
- Mongolia is not officially a HIPC country, but it seems to be a solid candidate if the transferable ruble debt were to be included in its external debt figures.
- The Enhanced HIPC Initiative approved in December 1999 provides for debt reduction in NPV terms of up to 90% or more on a case-by-case basis.
- Under the official Russia valuation framework Mongolia’s TR10.3 billion debt is equivalent to US\$17.6 billion, 1,706% of GDP and 3,240% of exports. At an exchange ratio of TR1 = US\$1, the debt is equal to US\$10.3 billion, 1,000% of GDP and 1,900% of exports. Even with a stylized Paris Club stock-of-debt reduction under Naples (50-67%) or Lyon (up to 80%) terms, the remaining debt would exceed by a wide margin conventional measures of a “sustainable” debt load.
- These hard currency magnitudes of Mongolia’s Soviet-era debt are entirely arbitrary with no relevance to the capacity of the Mongolian economy to produce resources for debt service. There is no international formula, convention, rule, or precedent in the history of international sovereign rescheduling to solve this arbitrariness.
- An evaluation of debt capacity and sustainability is the only way to determine the amount of the TR debt Mongolia could accept – if any. Using as a guide the

Enhanced HIPC “sustainability” threshold of 150% of exports, a sustainable level for Mongolia’s external debt is US\$800-900 million. Mongolia’s end-1999 external debt level of US\$855 million, suggests that a “HIPC sustainable” level of external debt for Mongolia will require a write-off of substantially all of the TR debt to Russia.

- Any amounts of the TR debt that are accepted by Mongolia, would become part of the external debt on a par with all other debt for all purposes including IMF surveillance and assessment of international rating agencies. Any difficulty in servicing these amounts would have adverse consequences for Mongolia’s presence in international capital markets.
- The probable election of President Vladimir Putin later this month could create an opportunity to solve the debt problem. First Deputy Prime Minister Mikhail Kasyanov is expected to have a senior post in the new government. He as the top expert in the Russian Government on debt and may be inclined toward a realistic approach to the TR claims on Mongolia based on sustainability.
- The delay in resolving the transferable ruble debt issue may be holding back Mongolia’s development. Mongolia must rely on a close economic relationship with Russia in the future. The enormity of the TR claim may be a subtle barrier to new investment, as it raises the question of why Russia does not seem to want to remove this burden on its relationship with Mongolia.
- Mongolia should shift from a passive to an active strategy. It should not leave this to the readiness of Russian officials. A passive strategy may be hurting Mongolia, and hampering its ability to attract international capital.
- The Mongolian Government should begin preparing a proposal. This proposal should have three main parts:
 - Restructuring terms that are required to achieve “sustainability”,
 - A detailed analysis of “sustainability” including fiscal and balance of payments constraints on government payment capacity,
 - A detailed synopsis of the historical record, including perhaps a case study of project lending decision making during the prior “era.”

Appendix 1:

Summary of the Russia-London Club Agreement, February 11, 2000 a/

Eligible Debt:

	<u>US\$ billion</u>
Principal Loans (Prin)	22.2
Interest Arrears Notes (Ian)	6.8
Estimated Past Due Interest b/	<u>2.8</u>
Total London Club Debt	31.8

Prins and Ians to be exchanged for new Russia Federation Eurobonds, due 2030

Past due interest to be exchanged for new Russia Federation Eurobonds, due 2010

Cash downpayment on Past Due Interest equal to 9.5% of the total

Terms of the Exchange:	Exchange <u>Ratio</u>	Discount <u>at Conversion</u>	PV Forgivnss <u>Bond Flows</u>	Total <u>Forgiveness</u>
Principal Loans	62.5%	37.5%	35.0%	59.4%
Interest Arrears Notes	67.0%	33.0%	35.0%	56.5%
Estimated Past Due Interest	100.0%	0.0%	0.0%	0.0%
Weighted Average Discount on Prins & Ians		36.4%	35.0%	58.7%

New Instrument Terms:

Russia Federation Eurobonds, due 2030

Final Maturity: 30 years

Grace: 7 years

Amortization:

47 semi-annual installments, commencing 31 March 2007

installments 1-4 0.5%

installments 5-7 2.0%

installment 8 2.5%

installments 9-24 3.0%

installments 25-28 4.0%

installments 29-32 3.0%

installments 33-36 2.0%

installments 37-47 0.5%

Interest:

Payable semi-annually in arrears

year 1, first period 2.25%

year 1, second period 2.50%

years 2-7 5.00%

years 7-30 7.50%

Russia Federation Eurobonds, Due 2010

Final Maturity: 10

Grace: 6

Amortization:

9 equal semi-annual installments commencing 31 March 2006

Interest:

Payable semi-annually in arrears at 8.25% per annum

a/ Source: Joint Russia Federation-London Club Press Statement and Term Sheet,
dated February 11, 2000 and author's estimates

b/ Estimated during period from default date, December 7, 1998 through March 31, 2000

Appendix 2:

Selected Stock-of-Debt Restructuring Agreements on Russian Transferable Ruble Claims

Debtor	Agreement Date	Amount Covered		Terms
		Total 1/ (million)	2/	
Madagascar	Fall-1992	US\$2,250	D	90% discount, US\$225mm remaining annual payments of US\$21mm (P+I) 1991-95 of which US\$15.5mm in merchandise
Jordan	Oct-92	US\$614	D, A	Buyback at 50% cash and merchandise payable in 1992 and 1993, cost US\$307mm
Tanzania	Jan-93	US\$635	D, A	Payment of US\$22mm in 1993 interim, 1-year agreement
India	Jan-93	TR6,350	D, A	Step 1: converted into 319 billion rupees at January 1, 1990 rupee-ruble exchange rate (19.9) Step 2: converted into 187 billion rupees at April 1, 1992 rupee-ruble exchange rate (31.8) Rs.187 billion rupees repaid on original terms Rs 132 billion (319-187), 45 years, 0 years grace 0% interest
Algeria	Early 1994	TR1,000	D	10 years, interest at 2% p.a. provision for partial payment in kind
Egypt	Dec-94	TR1,000 £22	D, A	Cancellation of military debt 25 years, 0 years grace for majority remainder at 8 years, 0 grace Sterling-denominated debt by 2001 Payments drawn from creditor balance in defunct clearing account
Laos	1993-94	TR796	D	Payments with merchandise exports valued at Rub5 million p.a.
Bulgaria	Late-1994		D	
Poland	Feb-95	?	D	converted from TR at x.x per US\$1
Hungary	1995	?	D	converted from TR at 5.5 per US\$1
GDR	1995	?	D	converted from TR at 6 per US\$1
Kyrgyz Rep	Dec-96	US\$133	D	10 years, 3 years grace, interest at Libor
Angola	Nov-96	US\$5,000	D, A	70% discount, US\$1,500mm, remainder 20 years, 5 years grace, interest at Libor
Nicaragua	Oct-96	US\$3,400	D, A	90% discount, US\$340mm, remainder 15 years, 0 grace, interest at Libor+.04%
Nigeria	Oct-96	DM3,000	D	Buyback at discount of 68%, cost DM960mm
Peru	Jun-96	US\$1,000	D, A	Swap for Russian commercial bank debt effective discount = 87%, cost = US\$130mm
Ukraine	May-97	US\$3,100	D, A	Initial payment US\$900 million (o/w US\$500mm on arrears) remainder in annual installments of US\$98mm
Pakistan	Dec-99	US\$200	D	Under Paris Club, 33% write-off, remainder 18 years, 3 years grace, 2.5% interest p.a.

Source: IMF, "Official Financing for Developing Countries," various issues. World Bank Debt Tables, various press reports.

1/ Debt eligible for restructuring, expressed in value and not necessarily in original denomination

2/ D = Medium/long term debt, A = arrears on D, I/P = interest/principal on medium/long term debt+A22

7. Footnotes

^{1/} Dresdner Kleinworth Benson, *Emerging Markets Research*, various issues February 2000.

^{2/} Dresdner Kleinworth Benson, *Emerging Markets Research*, various issues February 2000.

^{3/} *Financial Times*, “Russia Seeks Debt Write-off.” November 16, 1999.

^{4/} CMEA members were: USSR, Bulgaria, Czechoslovakia, Cuba, German Democratic Republic, Hungary, Mongolia, Poland, Romania and Vietnam.

^{5/} “External Debt of the Baltic Countries, Russia, and the Other Countries of the Former Soviet Union, and Russian Claims on Developing Countries,” Appendix III, *Official Financing for Developing Countries*, IMF, December 1995, pp. 80-99.

^{6/} A stock-of-debt agreement is a restructuring which treats the entire stock of debt and is usually intended as a permanent resolution.

^{7/} This is not the case for Vietnam, for example, which in 1994 received debt reduction on a large Paris Club debt (excluding its TR claims) under Naples terms (50-67% forgiveness) in 1994.

^{8/} *Debt Relief for Low-Income Countries: The Enhanced HIPC Initiative*, David Andrews, Anthony R. Boote, Syed S. Rizavi, and Sukhwinder Singh, IMF Pamphlet Series No. 51 –1999, p. 3.

^{9/} Ibid., p. 11.

^{10/} Ibid., p. 3.